Bundesverband Deutscher
Kapitalbeteiligungsgesellschaften

June 2nd, 2022

<u>VIA ELECTRONIC SUBMISSION</u>
Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (SEC Release No. IA-5955; File No. S7-03-22 (February 9, 2022)).

Dear Ms. Countryman!

We are writing on behalf of the German Private Equity and Venture Capital Association e.V. (BVK), the association representing Germany's private equity and venture capital sectors, as well as their investors. Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. Our association unites the interests of our 300 members. Nearly 200 of our members are private equity firms that invest in German companies in the form of venture capital, growth financing or buyouts. We also have institutional investors among the ranks of our members. Moreover, we represent almost 100 consultancy and law firms that work with private equity firms.

We therefore welcome the opportunity to provide feedback on the U.S. Securities and Exchange Commission (the "<u>SEC</u>") proposals relating to private fund advisers (Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022) ("<u>Private Funds Rules Proposing Release</u>")) under Investment Advisers Act of 1940 (the "<u>Advisers Act</u>") and in particular Rule 206(4)-10 (the "<u>Private Fund Audit Rule</u>"); Rule 211(h)(2)-1 (the "<u>Prohibited Activities Rule</u>"), Rule 211(h)(1)-2 (the "<u>Private Fund Quarterly Statements Rule</u>"), Rule 211(h)(2)-2 (the "<u>Adviser-Led Secondaries Rule</u>"), and Rule 211(h)(2)-3 (the "<u>Preferential Treatment Rule</u>"; together the "<u>Private Fund Rules</u>").We would like to note that we prepared this response in coordination with national European trade associations. As most European jurisdictions are subject to a similar financial services regulatory framework, either because they are subject to European Union (EU) law or because their legislative corpus is largely derived from EU law (this is for example the case of the UK), our responses were prepared jointly and are therefore very similar.

Bundesverband Deutscher
Kapitalbeteiligungsgesellschaften –
German Private Equity and Venture
Capital Association e.V. (BVK)

Residenz am Deutschen Theater
Reinhardtstraße 29 b
10117 Berlin
Telefon +49 30 306982-0
Telefax +49 30 306982-20
bvk@bvkap.de
www.bvkap.de

Deutsche Bank AG
IBAN DE34 1007 0024 0012 1251 00
BIC DEUTDEDBBER
Commerzbank AG
IBAN DE81 1008 0000 0930 1100 00
BIC DRESDEFF100

Sitz/Vereinsregister
Berlin, Amtsgericht
Charlottenburg 9378 NZ

Geschäftsführendes Vorstandsmitglied:
Ulrike Hinrichs

How The Proposed Private Fund Rules Affect Our Members

Most of our members are investment advisers with a principal place of business outside of the United States ("non-U.S. advisers"), who principally provide advice with respect to private funds organized outside of the United States ("non-U.S. private funds"). Certain of our members may be subject to the jurisdiction of the Advisers Act due to one or more of the following: (i) soliciting U.S. persons to invest in their private fund, (ii) maintaining a place of business, subsidiary or affiliate in the United States, or (iii) providing advice with respect to U.S. private funds or other types of U.S. clients. The perspective and feedback set out in this letter is therefore principally that of non-US advisers advising non-US funds.

Most of our members who are subject to the Advisers Act rely on the following exceptions from registration under the Adviser Act: (i) the foreign private fund adviser exemption in Section 203(b)(3) ("foreign private advisers") or (ii) either of (a) the venture capital fund adviser exemption in Section 203(l) or (b) the private fund adviser exemption in Section 203(m) (together "exempt reporting advisers") and our comments are hence limited to that group of advisers.

General Comments

First of all, we would like to clarify that, as we are an association based outside the US, our feedback does not comment on the lawfulness of the Private Fund Rules (in relation to which we refer the SEC to the feedback provided by the AIC). Instead, we focus strictly on and make recommendations relating to the proposals' policy, practical and commercial implications.

That said, we would like to share with the SEC a general concern with the appropriateness of any proposals, as they create regulatory interference in commercial agreements will hamper investors' freedom and ability to negotiate terms that work for them.

Without prejudice to any examinations of legality, we are in favour of transparency as a principle but argue that market practice, investor pressure and a combination of voluntary reporting frameworks and mandatory rules already achieve the necessary level of transparency. Most importantly, we fundamentally disagree with the prescriptive approach that has been taken by the SEC and by the extent of its territorial scope.

Should the SEC seek to impose new rules – preconditioned on such actions being legal in the first place – these should remain principles-based and should never seek to impose strict conditions on a private relationship between two experienced and professional negotiating parties.

We invite the SEC to examine how these principles are followed in existing European law and regulation which, although often too prescriptive in its reporting requirements, does tend to acknowledge the basic principle of contractual freedom between sophisticated parties and clearly makes a distinction between professional and retail-aimed rules. To that extent, we note that the Private Fund Rules clearly have the potential to render the U.S. less competitive compared to other jurisdictions, whilst reducing the range of investment choices available to U.S. investors.

Most problematically from a European perspective, elements of the Private Fund Rules that will apply to non-U.S. advisers will create serious conflicts of laws issues – as these firms are already subject to existing regulation in their home jurisdictions, often designed to achieve similar policy objectives and provide similar protections to investors. We detail further in Section 3 and elsewhere how some of the Private Fund Rules are likely to conflict with non-US law. The SEC should recognise that the Private Fund Rules should not apply to non-U.S. advisers advising on non-US funds.

Finally, we note that the proposal lacks a grandfathering clause and suggest inserting such a clause into the framework.

Extraterritorial Application to Non-U.S. Investment Advisers

The Prohibited Activities Rules Should Not Apply to Relationships Between Non-U.S. Advisers and Non-U.S. Funds Based on Long-Standing SEC Interpretation of Extraterritorial Limitations. The SEC has proposed that the Prohibited Activities Rule would not apply to a registered non-U.S. adviser with respect to non-U.S. private funds.[1] We support this position as it is consistent with the long-standing view of the SEC and the SEC staff that most of the substantive provisions of the Advisers Act should not apply with respect to a non-U.S. adviser's relationship with its non-U.S. clients and non-U.S. funds (including funds with U.S. investors).[2]

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[1] Private Funds Rules Proposing Release at p. 134 – 135 ("Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors.")

[2] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992), available at https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf ("Protecting Investors Study") at 229 ("[c]omity suggests that the Advisers Act should not apply to a foreign registered adviser's relationship with its non-United States clients outside the United States, just as the Commission would not expect the laws and regulations of a foreign country to apply to a United States adviser's relationship with its United States clients"); Uniao de Banco de Brasileiros S.A., SEC Staff No-Action Letter (July 28, 1992) ("Unibanco")("Under the Division's approach, the substantive provisions of the Advisers Act generally would not apply with respect to a foreign registered adviser's non-United states clients"); Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release No. IA-2333 (Dec. 2, 2004) ("Hedge Fund Adviser Registration Adopting Release") at fns. 211 – 213 and the accompanying paragraph (stating that that "the substantive provisions of the [Advisers Act] generally would not apply to the offshore adviser's dealings with the offshore fund."); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign

This SEC position has been based on the following main principles:

- *Investor Expectations*: Both U.S. and non-U.S. investors in non-U.S. funds "do not expect, and may not desire, a foreign adviser to be subject to the Advisers Act."[3]

- *International Comity/Conflicts of Laws*: Applying all of the substantive provisions of the Advisers Act to a non-U.S. adviser's non-U.S. advisory business "could result in inconsistent regulatory requirements or practices imposed by the regulations of their local jurisdiction and the U.S. securities laws."[4]

- *Detrimental U.S. Market Impacts*: Applying all of the substantive provisions of the Advisers Act to a non-U.S. adviser's non-U.S. advisory business would deter non-U.S. advisers from engaging in activities that would subject themselves to the Advisers Act, which would result in U.S. investors being deprived of the expertise of non-U.S. advisers.[5]

We request the following clarifications on the guidance with respect to the extraterritorial application of the Private Fund Rules.

Confirm That Same Extraterritorial Interpretation Applies to Exempt Reporting Advisers and Foreign Private Advisers. The release language with respect to the Prohibited Activities Rule was limited to registered non-U.S. advisers. Since the Prohibited Activities Rule would apply to all investment advisers (including exempt reporting advisers and other unregistered advisers), we request that the SEC confirm that this interpretation applies to all non-U.S. advisers, regardless of their registration status. We can think of no reason why the substantive provisions of the Advisers Act would apply to non-U.S. exempt reporting

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Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011)("Exemptions Adopting Release")(re-iterating "long-held view that non-U.S. activities of non-U.S. advisers are less likely to implicate U.S. regulatory interests and that this territorial approach is in keeping with general principles of international comity").

[3] Protecting Investors Study at 229; Hedge Fund Adviser Registration Adopting Release at fn. 213 (stating that "U.S. investors in [a non-U.S. fund advised by a non-U.S. adviser] generally would not have reasons to expect the full protection of the U.S. securities laws.")

[4] Exemptions Adopting Release at fn. 393 and the accompanying text (citing the Protecting Investors Study); Unibanco (expressing concern that "the Advisers Act may prohibit them from engaging in business practices with their foreign clients that are both legal and customary in their home countries."); Hedge Fund Adviser Registration Adopting Release at fn. 213 (nothing that "[t]he laws governing such a fund would likely be those of the country in which it is organized or those of the country in which the adviser has its principal place of business.").

[5] Protecting Investors Study at 229 (discussing "the unfortunate effect of limiting United States investors' access to foreign advisory expertise"); Hedge Fund Adviser Registration Adopting Release at fn. 213 (noting that "as a practical matter, U.S. investors may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules").

advisers or foreign private advisers to a greater extent than registered non-U.S. investment advisers. The principles for limited extraterritorial effect are stronger with respect to non-U.S. exempt reporting advisers and foreign private fund advisers, as the SEC recognized when adopting the rules implementing those exemptions.[6] We believe that applying these Rules to non-U.S. exempt reporting advisers with respect to their non-U.S. funds would run counter to the SEC's goal of establishing "appropriate limits on the extraterritorial application of the Advisers Act" when adopting the implementing rules relating to the new exceptions established under the Dodd-Frank Act.[7]

Confirm That Same Extraterritorial Interpretation Applies to the Other Private Fund Rules. We request that the SEC clarify that the other Private Fund Rules, specifically (i) the Private Fund Audit Rule, (ii) the Private Fund Quarterly Statements Rule, (iii) the Adviser-Led Secondaries Rule and (iv) the Preferential Treatment Rule, also would not apply to non-U.S. investment advisers (registered and unregistered) with respect to non-U.S. private funds.

Consistent with Extraterritorial Principles. We believe that limiting the proposed Private Fund Rules in this fashion would be consistent with the general principles relating to the limits of the extraterritorial application of the Advisers Act discussed above. First, investors in non-U.S. funds of non-U.S. investment advisers generally do not expect the full protection of the Advisers Act and, therefore, we believe they would not expect the applicability of the Private Fund Rules. This would be particularly true with respect to non-U.S. exempt reporting advisers and foreign private advisers, whose investors often have little awareness of how the Advisers Act applies at all with respect to their investment in a non-U.S. fund. Second, there is a significant risk of conflicts between the Private Fund Rules and the laws and regulations of non-U.S. jurisdictions. This is particularly true due to the prescriptive nature of the Private Fund Rules, as opposed to the historically more principles-based approach of with respect to the anti-fraud provisions of the Advisers Act. Finally, the difficulties of complying with Private Fund Rules would present significant deterrence to non-U.S. investment advisers soliciting U.S. investors if it substantially increased their regulatory obligations under the Advisers Act (in addition to and duplicative of the regulatory obligations imposed on them by their home jurisdiction, often with the aim of achieving the same investor protections), which would

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[6] Exemptions Adopting Release at p. 96 (that Rule 203(m)-1 was "designed to encourage the participation of non-U.S. advisers in the U.S. market by applying the U.S. securities laws in a manner that does not impose U.S. regulatory and operational requirements on a non-U.S. adviser's non-U.S. advisory business.").

[7] Exemptions Adopting Release at fn. 320 and the accompanying sentence.

deprive U.S. investors the ability to access the investment expertise of many non-U.S. investment advisers.

Consistent With Extraterritorial Limitations on Advisers Act Rules Covering Similar Areas. We further note that the SEC has previously taken a similar position with respect to several existing rules that cover similar areas to the other proposed Private Fund Rules. For example, the SEC has taken the position that non-U.S. investment advisers are not required to comply with Rule 206(4)-2 (the "Custody Rule") with respect to their non-U.S. clients (including non-U.S. private funds).[8] The Custody Rule houses the existing audit requirements for private funds and it would be inconsistent from a policy perspective to treat the Private Fund Audit Rule differently. Similarly, the SEC has stated that a non-U.S. investment adviser is not required to comply with Rule 206(4)-1 (the "Marketing Rule") with respect to their non-U.S. clients.[9] Therefore, we believe that the SEC should take a similar position with respect to the Private Fund Quarterly Statements Rule. The SEC has taken the position that a non-U.S. adviser is not required to comply with the contractual requirements set forth in Section 205 of the Advisers Act with respect to its non-U.S. clients.[10] This position that the Advisers Act should not impose prescriptive requirements on the contractual relationships between non-U.S. investment advisers and non-U.S. clients supports why, among others, the Preferential Treatment Rule should not apply to such contractual relationships either. Finally, the SEC also took the position that prohibitions on principal transactions in Section 206(3) would not apply with respect to non-U.S. clients of non-U.S. advisers.[11] For similar reasons, we believe that the Adviser-Led Secondaries Rule should not apply since it appears to present similar (albeit less significant) conflicts of interest from principal transactions.

Furthermore, more generally, the SEC has also taken the same position with respect to virtually all of the prescriptive substantive provisions and rules of the Advisers Act, including, in addition to those mentioned above, Rule 204-3 (with respect to the delivery of brochures),[12] Rule 204A-1 (the Code of Ethics rule),[13] the withdrawn Rule 206(4)-3 (the cash solicitation rule),[14]

8 Hedge Fund Adviser Registration Adopting Release at fns. 218 – 220 and the accompanying sentence.
9 Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) at 63 – 64.
10 Hedge Fund Adviser Registration Adopting Release at fn. 221.
11 Hedge Fund Adviser Registration Adopting Release at fn. 221.
12 Hedge Fund Adviser Registration Adopting Release at fn. 221.
13 Hedge Fund Adviser Registration Adopting Release at fn. 222 and the accompanying sentence.
14 Hedge Fund Adviser Registration Adopting Release at fn. 221.

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Rule 206(4)-6 (the proxy voting rule),[15] and Rule 206(4)-7 (the compliance policies rule).[16]

Reasons for Exceptions to Extraterritorial Application of Prescriptive Rules Do Not Apply to the Private Fund Rules. There are two limited exceptions where the SEC applies prescriptive rules to non-U.S. investment advisers. First, the recordkeeping rule (Rule 204-2) enables the SEC "to monitor and enforce the adviser's performance of its obligations to its United States clients and to ensure the integrity of United States markets."[17] Even in this case, the SEC still significantly limits which parts of the books and records a non-U.S. adviser is required to follow.[18] We also note that Rule 204-2 does not apply at all to any non-U.S. exempt reporting advisers or foreign private advisers.

Second, the pay-to-play rule (Rule 206(4)-5) includes implicit extraterritorial limitations since it only applies with respect to contributions and other activities with respect to U.S. state and local government entities.

We see no reason why the SEC would take a different approach with respect to the extraterritorial application of the Private Fund Rules, since they are prescriptive rules that neither include the implicit extraterritorial limitations of the pay-to-play rule nor support the SEC's monitoring and enforcement of the adviser's relationship with its U.S. clients like the recordkeeping rule.

Specific Comments on the Proposed Private Fund Rules

In addition to the comments on the extraterritorial application of the Private Fund Rules set forth above, we also have several specific concerns with the proposed Private Fund Rules, both specifically with respect to non-U.S. advisers but also more generally to all private fund advisers.

Rules Applicable to All Investment Advisers

Prohibited Activities Rule

Limitations on Liability

The Prohibited Activities Rule prohibits a private fund adviser from seeking reimbursement, indemnification, exculpation, or limitation of liability for a breach of fiduciary duty, willful misfeasance, negligence or recklessness in providing services to the private fund.

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[15] Hedge Fund Adviser Registration Adopting Release at fn. 220 and the accompanying sentence.

[16] Hedge Fund Adviser Registration Adopting Release at fn. 218 and the accompanying sentence.

[17] Uninbanco at fn. 8 and the accompanying sentence.

[18] Hedge Fund Adviser Registration Adopting Release at fn. 216 and the accompanying sentence.

The SEC Should Separately Analyze the Proposed Restrictions on Limitations of Liability with Respect to Advisers Act Fiduciary Duty and Local Contractual Law Duties. We believe that the SEC should separately analyze contractual provisions that seek to shape the fiduciary duty of an investment adviser under the Advisers Act as compared to those that seek to shape the duties of the general partner, manager or other persons under the contract law of the applicable jurisdiction (or other equivalent laws or regulations). This is important because (i) the nature of the duties under the Advisers Act and contract law vary dramatically from each other, including the extent to which they are permitted to be shaped, modified or eliminated; (ii) the private rights of action under the Advisers Act and local contract law are substantially different; (iii) the nature of the duties under contract law vary materially between different jurisdictions (including both among U.S. states but also between the U.S. and the many non-U.S. jurisdictions); and (iv) the SEC's legal knowledge and authority with respect to the Advisers Act is significantly different than its knowledge of contract law across all U.S. and non-U.S. jurisdictions.

Local Contract Law Generally Permits More Shaping of Duties Than the Advisers Act. A general partner of a private fund generally is permitted to shape, modify and eliminate local contractual duties to much greater extent than it is permitted (as an investment adviser) to shape its Advisers Act duties. A contractual clause may seek to limit the liability of the general partner for actions under local contract law in a manner that is permitted under the local contract law[19].

However, a limitation of the same actions may not be permitted under the Advisers Act. Therefore, it would not be misleading or a violation of current law for such clause to limit liability only with respect to liability under local contract law and not the Advisers Act.

There Are Different Private Rights of Action Under Local Contract Law and the Advisers Act. The distinction between local contract law and the Advisers Act in this way is important because the private right of action with respect to the Advisers Act is much more limited than generally exists under local contract law. Currently, the sole private right of action for an advisory client is to sue for recission of an advisory contract entered into in violation of the Advisers Act.[20] Enforcement of violations of the Advisers Act are principally the responsibility of the SEC. On the other hand, clients generally have a right of action against any violation of an advisory contract under local contract law. This distinction in rights of action is one of the reasons why local contract law allows greater modification of the contractual duties. We are concerned that the SEC may create a "back door" private right of action for all of the Advisers Act by not only restricting exculpation and

[19] Private Funds Proposing Release at 150 – 151.
[20] Transamerica Mortg. Advisors, Inc. v. Lewis. 44 U.S. 11 (1979).

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indemnification clauses with respect to the Advisers Act but also under local contract law.[21]

There Are Many Different Jurisdictions in the United States and Outside of the United States With Different Contract Law. However, these restrictions of exculpation, indemnification and similar clauses under local contract law are problematic because it could expand liability in other ways due to differences in applicable contract law. We note that the SEC appears to focus solely on U.S. state law. There is an even greater amount of variation in contract law across non-U.S. jurisdictions. The SEC has made no showing or findings that would support restrictions on such clauses in all jurisdictions around the world for any investment adviser.

SEC's Expertise Is Federal Securities Laws Not Local Contract Law. This point highlights the last important reason for separately addressing Advisers Act duties and local contract law duties: The SEC is an agency with experience and expertise in the Advisers Act and other federal securities laws. It does not have the expertise or knowledge to be making restrictions on a core contractual principle like limitation of liability under contract law in jurisdictions throughout the United States and the world. This is a lesson that the SEC staff learned with respect to the anti-assignment clause requirement of Section 205(a)(2) where the SEC staff eventually stopped providing guidance as to what would constitute "consent" because it was a matter of local contract law.[22]

Increased Threat of Private Litigation Will Have Wide-Ranging Effects. This provision of the Prohibited Activities Rule would likely result in an increased threat of private litigation (and potential liability associated with such litigation) as a result of the expanded rights of action and limited ability to shape contractual duties discussed above. Such an increased risk of private litigation would increase the costs for investment advisers both relating to taking actions to mitigating those litigation risks and also in defending against such litigation. These effects will be wide-ranging: There will be increases to insurance premiums (or, in certain cases, an inability to get insurance). There will be increases to costs of additional internal and external legal review and support.

Threat of Litigation Will Affect Behavior of Advisers. There will also be a range of adverse behavioral consequences from the increased threat of litigation. Advisers will be less likely to make "risky" or unusual investments that may be in the best interests of the fund from a risk-reward analysis, but

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[21] See Private Funds Proposing Release at fns. 171 and 172 and the accompanying paragraph.
[22] See, *e.g.*, American Century Companies, Inc., SEC Staff No-Action Letter (Dec. 23, 1997).

present different litigation risks.[23] Small investment advisers without a robust in-house legal team or other access to sophisticated ongoing legal support will be placed at a competitive disadvantage to larger investment advisers. This will lead to less competition in the investment adviser market, as fewer persons decide to start new investment adviser firms, given the increased burdens.

Threat of Litigation Will Lead to Avoidance of United States. Furthermore, non-U.S. advisers will take additional actions to not be subject to the Advisers Act, because they do not want to deal with the unnecessary Advisers Act overlay on local contract law. Non-U.S. advisers are more likely to be wary of increased legal liability risk in the United States, where they may have little knowledge or experience. This would likely deprive U.S. investors of the ability to access certain non-U.S. funds in certain situations or the ability of U.S. companies to access the capital of non-U.S. funds.

Negligence Standard Is Inconsistent with Other Areas of Federal Securities Laws. The limitation of liability provision of the Prohibited Activities Rule also suffers from the fact that it is inconsistent with existing federal securities law. For example, the existing standard with respect to retail investors in U.S. registered investment companies is "gross negligence." Similarly, the liability standard under Rule 10b-5 under the Securities Exchange Act of 1934 requires scienter. Furthermore, the SEC is not proposing any similar requirement with respect to contracts with advisory clients other than private funds, including, for example, separately managed accounts for retail clients.

Proposed Liability Limitations Are Contrary To Recent Positions on Hedge Clauses. The proposed Rule would also be inconsistent with the recently adopted guidance with respect to the Advisers Act fiduciary duty where the SEC received comments on whether to prohibit so-called "hedge clauses."[24] The SEC specifically declined to do so stating that "[t]he question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication)."[25] Additionally, while the SEC expressed skepticism that a hedge clause for a retail client would be consistent with an adviser's fiduciary duty, the SEC stated that whether a hedge clause with an institutional client would violate the fiduciary duty depends on the facts and circumstances.[26] Given the very limited amount of time since this guidance, we see no reason for a proposal that would not merely ban hedge clauses but also impose a specified level of liability.

[23] See, *e.g.*, Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 Journal of Law & Economics 425-46 (1993).
[24] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (Jun. 5, 2019) at fn. 31.
[25] Fiduciary Duty Guidance at fn. 31.
[26] Fiduciary Duty Guidance at fn. 31.

Adviser Clawback for Taxes

In the context of private funds, profits are shared between the investors and carried interest recipients (typically individuals employed or engaged by the adviser) depending on the performance of the underlying investments. In some cases, there may need to be a clawback of carried interest to ensure investors and carried interest recipients receive the correct profit share amounts when looking at the overall results of the fund at the end of its life. In this situation it is typical for the carried interest recipients to have to return any such excess.

Clawbacks are Often Appropriate for Dealing with Unexpected Scenarios. Clawback is an important investor protection mechanism, which is often appropriate, even for a "whole fund" waterfall. For example, take a private equity fund of €120m with 20% "whole fund" carried interest, and assume €100m is drawn for five investments of €20m each. If the first four investments are sold for €30m, then under the "whole fund" waterfall, no carried interest would be paid on the sale of the first three investments. On the sale of the fourth investment (in say year eight) the first €10m would be distributed to investors (so they have been repaid their €100m in full), and then the remaining €20m would be split 80/20 (*i.e.* €16m to investors and €4m to carryholders[27]). The "whole fund" waterfall ensures that even if the last investment were written off in year ten, there would not be a clawback (as total profits are €20m (€120m over €100m) and the carried interest holders have received 20% of that €20m.

However, there are some scenarios where a clawback could occur due to events that were not envisaged at the time of the sale of the fourth asset (and accompanying carried interest distribution). For example, (i) there may be situations where the manager believes it is beneficial to make a follow-on investment into the fifth investment, in say year nine or ten (ii) litigation costs may arise in respect of an exit of one of the first four assets that the manager believes it is prudent to pursue; or (iii) there may be situations where the terms of an exit of one of the earlier investments require amounts to be returned by investors. Therefore, while whole fund models of carried interest distribution may make a clawback much less likely, they do not always remove the possibility entirely.

It is absolutely customary in the private equity and venture capital industry, and invariably accepted as reasonable by fund investors, for carried interest holders to not be "out of pocket" in a clawback situation. The clawback is not aimed at penalizing the manager or carry holders but rather to ensure carry holders do not retain "in pocket" amounts that should, on the final analysis, be paid to the investors. The carried interest typically is held by individuals

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27 In practice there would often be a preferred return protecting investors as well, but this has been removed for simplicity.

employed or engaged by an adviser, who are likely to incur tax liability when they are allocated a share of profits and receive the carried interest (in year eight in the example above) and in many jurisdictions may incur tax liability earlier than that (and prior to receiving any carried interest amounts), for example, if the valuation of the fund (on a liquidation basis) means that it is likely that they will receive carried interest.

Proposed Clawbacks on a Gross of Tax Basis Creates Undue Tax Penalties for Investment Adviser Teams. We would note that describing a clawback obligation as an "overpayment" of carried interest, may imply that there was a mistake at the time of calculation; this is not the case. Carried interest waterfalls are calculated in a way to try to ensure that the relevant economics are achieved as at the liquidation of the fund. However, as demonstrated above, this can only ever be done on a 'best estimates' basis and the final position can only be known once the fund has been fully liquidated and there are no further liabilities. We do not think therefore it is appropriate to penalize the team in situations where unforeseen events result in a contractual clawback.

In the example above if a further €15m of the original €120m were to be drawn for a follow-on (example (i) above) and ultimately written-off. The situations would be:

- Overall profits of €5m (€120m over €115m)
- Investors have received €1m of profits (in addition to €115m return of capital).
- Carried interest holders have received €4m of profits
- Carried interest holders would be obliged to return €3m to investors (so that the €5m profits have been split 80/20).

In the above situation if carried interest holders were subject to, say a 30% effective tax rate, then they would have received net carried interest of €2.8m and would be out of pocket for the remainder of €1.2m. This would be a situation where investors have received a profit on the fund and yet carried interest holders have not only handed back the benefit they have received (the after-tax carry) but also effectively suffered a loss of €200,000.

Requiring carried interest to be clawed-back on a gross of tax basis can therefore be unfair and unduly burdensome on the individuals within an adviser. Given that advisers and their investors are typically in favor of carried interest being spread widely across the Adviser's team, this could be particularly burdensome on junior executives who may not have sufficient assets to repay the clawback having already suffered the tax.

Reclaiming Tax or Tax Losses is Not Possible in Many Jurisdictions. In addition, we would note that personal tax liabilities vary materially between jurisdictions. In addition to the quantum of such tax, the ability of an individual to recover tax in the event that there is a clawback obligation varies materially from jurisdiction to jurisdiction.

It cannot be assumed that any such tax cost would be reversed, offset or reclaimable by individuals in the event that there is a clawback event, as most European tax regimes do not allow any such reclaim or offset and would not recognize any form of tax loss that could potentially be used by the individuals as a result of the clawback. In these circumstances, the tax on carried interest once triggered and due is likely to be an absolute cost which cannot be recouped directly or indirectly by the individuals who suffer it, even if there is a subsequent clawback event. Therefore, any obligation to refund carry on a gross of tax basis is likely to be disproportionately burdensome on advisers, and even more so for those with a team in diverse locations. In particular, this could disproportionately affect non-U.S. advisers if the Extraterritorial Limitations do not apply to them.

Furthermore, we are concerned that an obligation to require clawback to be returned on a gross of tax basis may force firms to take more conservative positions that could reduce overall returns to investors, in particular towards the end of the fund life. This could be through (i) deciding not to make follow-on investments to tail-end investments in situations where it may be beneficial to the ultimate returns to make such an investment (ii) deciding not to incur litigation or other expenses that may protect the fund's tail-end investments; (iii) retaining a greater amount of proceeds within the fund to maintain reserves to fund potential tail-end liabilities, reducing IRR to investors, and/or (iv) concentrating the carried interests in the hands of more senior executives and/or the adviser firm itself, who may be able to afford the risk of a gross of tax repayment (neither of which is attractive to investors from the perspective of proper alignment/incentivization).

It is worth noting that when the Institutional Limited Partners Association ("ILPA") released its first set of principles, it advocated a similar position to the one that the SEC has proposed. However, after many discussions between advisers and investors within the industry the later sets of principles changed this position and now acknowledge that the clawback may be net of tax where it is excessively burdensome or impractical given the application to individual members of the general partner. We believe that the SEC should take a similar position and leave the decision to be determined between investors and advisers in the context of the relevant situation.

Allocation of Fees and Expenses

"Unperformed" Services Are Generally a Misnomer For Payment Smoothing. With respect to payments for "unperformed" services or "accelerated payments" for monitoring and other services performed by the adviser or its affiliates for portfolio investments, the SEC seems to misunderstand the nature of these payments. The services performed by an adviser (or its affiliates) for a portfolio investment vary depending on the type of portfolio investment (*e.g.*, the type of company, where the company is in its life cycle, the business strategy of the company). It also varies depending on the stage in the life cycle of the fund's investment in the company. It is common to front load a lot of the services for a portfolio investment before and soon after the fund has made an investment. These upfront services can include a range of activities, including, for example, industry analyses and strategy development where the private fund adviser seeks to re-orient the portfolio investment on a more successful trajectory. However, it may be in the best interests of the private fund to smooth the payment for such services over the life of the portfolio company, so that the portfolio company is not unnecessarily burdened. This smoothing may naturally end at a liquidation event when the portfolio company will have additional capital with which it can pay for the services performed by the adviser. This structure of payment is not unique to the private fund industry. There are many situations (*e.g.*, intellectual property licenses) where the bulk of the payment may be triggered by a liquidity event. For these reasons, we believe that adequate disclosure of such fees should be sufficient, otherwise the adviser may be forced to re-structure the payment of such fees in a way that is not in the best interests of the private fund.

<u>Certain Fees and Expenses</u>

SEC Has Not Shown Problems with "Pass Through" Expense Models. For most members, we do not believe there would be a significant issue with the prohibition on an adviser from charging a private fund for fees and expenses associated with a governmental or regulatory examination or investigation and regulatory compliance fees and expenses of the adviser or its related persons. However, as noted by the SEC, there are a minority of advisers who operate on a "pass through" expense model. The SEC presents no findings or evidence that such "pass through" models harm private funds or their investors, provided there is adequate disclosure and policies and procedures relating to expense allocation. We do not know why the SEC would remove a business model that in other contexts has been found to be beneficial to investors.

Confirm Interpretation That Prohibition Does Not Apply to Fund-Related Expenses. We do stress that it is important that the SEC maintain the interpretative position that would exclude from this restriction the ability to charge for regulatory, compliance and other fees and expenses directly related to the activities of the private fund. Requiring an adviser to bear these fees and expenses would harm the private fund since the adviser may be less incentivized to engage in actions that are beneficial for the private fund, but increase the expenses borne by the adviser.

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Confirm that Fund-Related Expenses Includes Advisers Act Expenses Directly Related to the Fund. It is common practice for the fund to bear the expenses associated with engaging a custodian to maintaining its cash and securities and to engage an accountant to perform an annual audit. Both of these activities are also often used to comply with the Custody Rule. Similarly, some of the activities covered by the Private Fund Rules would overlap with activities that are usually paid for by the fund, including, for example, investor reporting in the Private Fund Quarterly Account Statements Rule, the annual audit in the Private Fund Audit Rule, the engagement of an opinion provider in the Adviser-Led Secondaries Rule, and the preparation of disclosures regarding side letter provisions in the Preferential Treatment Rule. In these situations, it is generally impossible to distinguish between regulatory and non-regulatory expenses. We request confirmation that a manager would not be required to bear these types of expenses.

<u>**Non-Pro Rata Fee and Expense Allocations**</u>

Non-Pro Rata Allocations Are Not the Norm But Generally Happen to Promote Fair and Equitable Outcomes Between Funds. We disagree strongly with the proposed prohibition on the ability of an adviser to allocate fees and expenses relating to a portfolio investment (or a potential portfolio investment) on a non-pro rata basis between multiple private funds or other clients advised by the adviser (or its related persons). It is true that in the vast majority of cases when more than one affiliated fund makes an investment in the same portfolio investment that the expenses are allocated on a pro rata basis. In our experience, most expense allocation policies and disclosures use pro rata allocation as the default in the such cases. However, these policies and disclosures also either provide specific exceptions where this is not the case or reserve the right for an adviser to re-allocate the fees and expenses where the adviser determines a pro rata allocation is not fair and equitable to the participating funds.

Conflicts Associated with Allocations Are Based With Disclosure and Informed Consent. The SEC notes that there are conflicts of interest relating to non-pro rata expense allocations and we agree. We agree that there are conflicts associated with such expense allocations. However, we believe the SEC fails to appreciate the diversity of investment structures that exist throughout the private fund industry. Each private fund or other client may have unique or differentiated tax, regulatory or other situations that would drive a non-pro rata allocation. A principles-based approach that relies primarily on disclosure to, and informed consent from, sophisticated investors makes the most sense where there is a lack of uniformity of how those conflicts are manifested.

Proposed Rule Would Not Create Better Allocation of "Broken Deal" Expenses for the Main Fund. The SEC seems particularly focused on the allocation of "broken deal" expenses but it also acknowledges that allocating such expenses to potential co-investors who have not entered into any contract is not possible.[28] We believe that, if adopted, this proposal would simply result in more main funds making the entire initial investment and then selling on a portion to a co-investment vehicle formed after the fact. Requiring this form would not result in any benefit to the fund, since it would remain on the hook for the entire "broken deal" expenses either way. In fact, it may be disadvantageous where holding the investment in the interim is riskier than simply admitting a newly-formed co-investment vehicle at or closer to the initial investment.

Preferential Treatment Rule

***There Should Be a Materiality Threshold for Preferential Treatment Disclosure*.** The SEC should adjust the disclosure requirements with respect to all preferential treatment to provide some materiality threshold similar to the prohibitions. Investors may negotiate for different treatment where it is questionable whether it is preferential or just individualized. Overwhelming investors with every instance where an investor received individualized treatment seems unnecessary.

Disclosures Made Pursuant to an MFN Process Should Satisfy the Disclosure Requirement. The SEC should adjust the rule to permit a private fund adviser to rely on its MFN process, whereby investors with MFN provisions receive information on a range of side letter or other provisions after closing. Since the MFN provisions are intended to ensure equality of treatment, it would appear unnecessary to require an investment adviser engage in a burdensome effort of completing this summary of provisions subject to MFN prior to closing. We would like to note that in the European Union, the AIFMD only requires that no investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's rules or instruments of incorporation. We believe this approach is much more appropriate than the AIC and fits with the realities of the industry.

Rules Applicable to Registered Investment Advisers: Private Fund Quarterly Statements Rule

The SEC states that the purpose of the periodic statements is to improve the ability of investors to (i) compare their private fund investments, (ii) monitor compliance with the private fund's governing agreements and disclosures, and (iii) better understand the impact of the fees and expenses on the private fund's performance.[29]

Confirm Private Fund Quarterly Statements Rule Does Not Apply to Non-U.S. Funds of Non-U.S. Advisers. As discussed in more detail above and consistent with its long-standing position on the extraterritorial application of the Advisers Act, we request confirmation that the Private Fund Quarterly

[28] Private Funds Proposing Release at fn. 180.
[29] Private Fund Rules Proposing Release at p. 18.

Statements Rule will not apply with respect to a non-U.S. adviser's relationship with a non-U.S. private fund. We note that other non-U.S. jurisdictions may have or may implement in the future reporting requirements with respect to private funds that could conflict with the Private Fund Quarterly Statements Rule. Therefore, to prevent future conflicts of law (among other reasons), we believe there should be limited extraterritorial application of the Private Fund Quarterly Statements Rule.

Exclude Where Subject to Rule Solely Due to U.S. Sub-Adviser. We further believe that a non-U.S. fund should not be required to make quarterly statements in accordance with the Private Fund Quarterly Statement Rule solely because it (or its primary adviser) engages a U.S. sub-adviser. In many cases, the sub-adviser is not responsible for all of the private fund investments, for ensuring compliance with the private fund's governing agreements and disclosures or the allocation of the fees and expenses. It would therefore need to impose a burden on the non-U.S. primary adviser in order to comply with the Private Fund Quarterly Statements Rule. As a result, the non-U.S. primary adviser would be less likely to engage a U.S. registered adviser as a sub-adviser. We believe that the general principles of limited extraterritorial application of the Advisers Act would also apply in these situations.

The Purposes of the Rule Could Be Met with Less Frequent (i.e., Annual) Reporting. The SEC does not provide any basis for why the reporting should be done on a quarterly basis, particularly with respect to closed-end funds that do not permit redemptions in the ordinary course of business. Many private fund advisers provide quarterly reports to investors, but this reporting is done on an unaudited basis to reduce the burdens on the fund associated with the reporting. However, we believe the SEC's approach should reflect the fact that there are also cases where investors in certain private funds to do not want quarterly reporting because some investors do not want the fund to bear the costs associated with quarterly reporting and do not believe information provided on a quarterly basis is necessary. Furthermore, it would appear unlikely that many (if any) investors would engage in detailed analysis of fee and expense information on a quarterly basis either for understanding performance or for monitoring compliance with the governing documents and disclosures, particularly in the case of a closed-end fund where there are no redemptions in the ordinary course. The increased granularity of fee and expense reporting may actually be less useful for investors because the investors may be confused with the natural quarterly variations in fees and expenses through the year but also through the life of the fund. We believe that if there is to be a new requirement to disclose fees and expenses and performance that it should be tied with the traditional annual audit process in order to reduce the burdens and costs to the private fund investors. We believe that tying it to the audit process would also increase the accuracy of the statements and reduce the likelihood of errors that may lead to more investor confusion.

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The SEC Should Permit New Funds a Full Year to Comply with the Performance-Reporting Requirements. The SEC would currently require a private fund adviser to start reporting on a private fund's performance in its second quarter. With respect to many private funds and most funds investing in illiquid portfolio companies, the performance for at least the first year, as the fund's portfolio remains in early construction, is of little value. It is common practice in current performance presentations to present some number as either "not material" or "not applicable." The SEC should not cause a private fund adviser to report information that may lead to greater investor confusion.

The SEC Should Provide Guidance on the Level of Detail for Each Fee and Expense Category. The SEC should provide more clarity as to how narrow each category of expense should be as a separate line item. The SEC only states that it should list each "specific category of expense" and that it should not "group fund expenses into broad categories."[30] "Specific" and "broad" are relative terms. Clearly, the SEC would not expect an adviser to list fees by each vendor or by each invoice. Therefore, advisers will be required to engage in some level of discretion. We recommend that the level of detail be tied to the disclosures provided to investors (*i.e.*, a private fund sponsor should generally categorize the fees and expenses in the quarterly statements in accordance with the categories of fees and expenses set forth in the fund governing documents and disclosures).

The SEC Should Permit Aggregated Reporting of Private Funds with SPVs, AIVs, etc., as well as Master-Feeder Fund and Parallel Fund Structures. We support the SEC's position that would permit aggregated reporting on master-feeder and parallel fund structures.[31] Private funds may also utilize a variety of aggregators, special purpose vehicles or alternative investment vehicles to facilitate one or more investments. We believe that, in order to satisfy the purposes of the Rule, any statements should be provided with respect to the private fund in which the investor has invested where the private fund adviser may aggregate with respect to any alternative investment vehicles or special purpose vehicles utilized to make investments. The SEC suggests that instead of aggregated reporting in these situations that the adviser should distribute the quarterly reports of the underlying special purpose vehicles to the main fund investors.[32] Taking this approach would just increase the burden on private fund advisers while creating more investor confusion, who are generally not interested in nor aware of the exact nature of the special purpose vehicles used to facilitate investments. The more relevant information for an investor would be to receive a quarterly statement with respect to the private fund in which it invested

30 Private Fund Rules Proposing Release at p. 18 – 19.
31 Private Fund Rules Proposing Release at p. 91 – 92.
32 Private Fund Rules Proposing Release at p. 86 – 87.

directly on a consolidated basis with any underlying special purpose vehicles and alternative investment vehicles.

The Private Fund Quarterly Statement Rule Should Be Permitted to Be Waived by Investors in at Least Certain Circumstances. As noted above, in certain circumstances, investors in private funds do not require and do not want quarterly statements because the investors have determined that the costs of such statements exceed the value to the investors. The SEC should consider permitting investors in a private fund to waive compliance with the Private Fund Quarterly Statement Rule in such circumstances as well. If the SEC is not willing to provide a general ability to waive, then the SEC should consider providing exceptions or waivers in the following circumstances: (i) co-investment vehicles formed for the purpose of making a single investment or a set of related investments; (ii) closely-held private funds where private funds have received consent from a super-majority of the investors to waive the quarterly statement requirement; (iii) employee funds and friends-and-family funds; (iv) single investor vehicles; and (v) private funds held by large institutional investors (*e.g.*, qualified institutional buyers).

The SEC Should Narrow Its Look Through Requirements with Respect to Definition of "Portfolio Investment." The SEC suggests that a "portfolio investment" would capture entities that are held through "holding companies, subsidiaries, acquisition vehicles, special purpose vehicles, and other vehicles through which investments are made or otherwise held by the private fund." As indicated in our prior comment, we agree that acquisition vehicles and special purpose vehicles should be "looked through" or aggregated with the main private fund with respect to the Private Fund Quarterly Statement Rule. However, we disagree that it should be required to look through "holding companies" or "subsidiaries" of such holding companies. A holding company is often the "portfolio investment" of the private fund that is engaged in a business, either directly or indirectly, that is different from the private fund. It would generally be a facts and circumstances analysis of determining what is a "holding company" and what is a "special purpose vehicle" or "acquisition vehicle" formed to facilitate an investment; however, one would look at, among other factors, (i) whether the private fund sponsor or an affiliate acts as general partner, managing member or equivalent of the entity, (ii) whether, in connection with any sale of the portfolio investment, the private fund would expect to sell its interest in the company or to cause the company to sell its interests in an underlying entity (*i.e.*, generally a private fund would expect to sell its interest in a holding company but would expect to cause a special purpose vehicle to sell its interest in an underlying entity), (iii) whether the directors, officers or other persons of the entity are the same as or substantially overlap with the directors, officers or other employees of the underlying operating subsidiaries, (iv) whether the entity existed prior to the investment of the private fund, (v) whether management of the company owns an interest in

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the entity (*i.e.*, management would generally invest in a holding company but not a special purpose vehicle) and (vi) whether the entity is held out to investors as a "holding company" or an "investment vehicle" that is a client of the private fund adviser, including by how its named. We note that these types of determinations are often undertaken by registered investment advisers with respect to which entities are subject to an audit under the Custody Rule.

In addition, we believe that a private fund that is a fund-of-funds should not be required to look through any underlying private fund with respect to their portfolio investments. The private fund advisers of such underlying private funds would have their own obligations under the Private Fund Quarterly Statement Rule, so applying it at the fund-of-funds level would be duplicative and confusing to the investors of the fund-of-funds. Requiring a fund-of-funds to look through the underlying funds would represent a complete misunderstanding of the business model of fund-of funds.

The SEC Should Not Define Liquid Fund and Illiquid Fund but Should Let an Adviser Choose the Most Appropriate Approach. As discussed more fully below, we do not believe that the SEC should be dictating what method is used to calculate performance given the diversity of types of private funds (as the SEC recognized in adopting the Marketing Rule).[33] However, if it does, it should permit a private fund adviser to choose the appropriate calculation method for its type of fund, rather than trying to use the definitions of "liquid fund" and "illiquid fund" that it has proposed. The goals of providing standardized performance would still be accomplished but it would allow the private fund adviser to decide which performance metric is most appropriate for its fund.

The SEC Should Not Re-Open Policy Choices Already Made in the Marketing Rule. In several respects, the Private Fund Quarterly Statement Rule is re-visiting policy choices already made in the recently adopted Marketing Rule and taking an inconsistent approach.[34] The SEC has not even given time for the compliance date for the Marketing Rule to pass before pre-judging its effectiveness. The SEC unconvincingly argues that the change in approach is due to the differences in the needs of current investors versus the needs of prospective investors. Specifically, the SEC states that current clients need to be able to (i) evaluate an investment alongside corresponding fee and expense information and (ii) receive performance reporting at timely, predictable intervals so that they can monitor the investment and take action

[33] See Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) ("Marketing Rule Adopting Release") at p. 170 (Noting that the SEC believed "that, because of the variation among types of advisers and investments, prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful to an advertisement's audience").

[34] Marketing Rule Adopting Release at p. 165 – 175.

where possible. As discussed below, these justifications do not actually explain all of the differences in the approach and also do not line up with reasons set forth by the SEC in adopting release of the Marketing Rule. Furthermore, this justification runs counter to the long-standing position of the SEC that communications with existing investors should be subject to less regulatory oversight than communications with prospective investors.[35]

The SEC Already Decided That a Detailed Fee Schedule Was Unnecessary to Understand Effect on Performance. The SEC states that one of the purposes of the Private Fund Quarterly Statements Rule is to permit investors to better understand the implication of fees and expenses on performance.[36] The SEC, however, recently considered this argument with respect to the adoption of the new Marketing Rule (where it had proposed a detailed fee schedule) and decided "we believe requiring net performance for all advertisements with appropriate disclosures will alert investors to the effect of fees on an adviser's performance results."[37]

The SEC Should Not Determine How Performance Is Calculated. The SEC is proposing requiring that (i) a liquid fund report on its performance based on net total return since the fund's inception, over prescribed time periods, and on a quarterly basis for the current year and (ii) an illiquid fund report on its performance based on the internal rate of return and a multiple of invested capital. The SEC recently decided not to prescribe the method of performance calculation in adopting the Marketing Rule due to the "variation among types of advisers and investments."[38] Neither of the justifications for the differences discussed above in the Marketing Rule and the Private Fund Quarterly Statement Rule apply to requiring standardized performance metric. The SEC then justifies standardized performance metrics to facilitate comparisons across various private funds. This justification is actually stronger for a prospective investor considering a future investment than it is for a current investor evaluating the success of a current investment. This

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[35] Marketing Rule Adopting Release at p. 16 (noting that the SEC was modifying the proposed rule to "facilitate communications with existing investors"). Note that this is not to say that communications with existing investors are not subject to any regulatory requirements, since these communications remain subject to Rule 206(4)-8 under the Advisers Act. *See*, *e.g.*, *id.* at fn. 95 (referencing the existing SEC staff no-action letter guidance excluding communications with existing investors from the Advertising Rule); and fn. 96 and the accompanying sentence ("We believe that other protections prevent advisers from engaging in activities that mislead or deceive existing investors" (citing section 206 and Rule 206(4)-8)).

[36] Private Fund Rules Proposing Release at p. 18.

[37] Marketing Rule Adopting Release at 168 ("While one commenter disagreed, arguing that investors in private funds (including Non-Retail Persons) sometimes have difficulty obtaining information regarding fees and expenses for complex products, we believe requiring net performance for all advertisements with appropriate disclosures will alert investors to the effect of fees on an adviser's performance results.")

[38] Marketing Rule Adopting Release at 170.

suggests that the SEC is unnecessarily re-visiting a policy choice it has very recently decided upon without giving it an opportunity to evaluate the pros or cons of that policy choice.

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We hope that the above is clear and helpful and remain of course available to discuss or comment on any of the above.

Best regards,

Ulrike Hinrichs
Executive Board Member

Patricia Volhard
Board Member